PENDAL

Pendal Monthly Commentary

Pendal Sustainable Future Australian Shares Portfolio

October 2020

Market commentary

The S&P/ASX 300 rebounded from the previous month's weakness to post a 1.9% gain in October.

Returns would have been far greater, but for a sharp fall as polls narrowed in the US Presidential election and Covid cases jumped in the US and Europe.

Optimism at the relaxation of domestic restrictions, particularly in Victoria, helped support the local market.

The federal government delivered a stimulatory budget which emphasised the degree to which policy makers are determined to cushion the economic impact of Covid and support a recovery. This remains an important supporting factor for markets.

Technology (+8.96%) was the best-performing sector as growth stocks continued to surge domestically despite an uptick in US bond yields.

There was also life in Financials (+6.27%), which have been a laggard over the last year. The prospect of easing regulation around responsible lending laws – as well as bad and doubtful debts tracking towards the more benign end of expectations – helped support the banks. More broadly, the sector responded well to rising US bond yields.

Industrials (-3.48%) underperformed, dragged down by infrastructure stocks Transurban (TCL, -4.6%) and Sydney Airport (SYD, -7.0%) as US bond yields rose. A surge in international Covid cases suggested international travel is likely to take longer to normalise than other recovery trades, which weighed on transport-linked stocks.

The low cost of capital – and in some sectors low valuations – is driving some interest in mergers and acquisitions.

Coca Cola Amatil (CCL, +30.8%) provided a high profile example in October as it came under offer from Coca-Cola European Partners. We expect takeover speculation to remain a factor in near-term markets, providing an additional degree of support.

Portfolio overview

Sustainable Future Australian Shares Portfolio	
Investment strategy	To deliver outperformance relative to the benchmark before fees over a rolling five year period by investing in companies which Pendal has identified as having leading financial, ethical and sustainability characteristics.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15-40 (25 as at 31 October 2020)
Sector limits	Cash 2-10%
Dividend Yield	3.48%#

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	10.80%
CBA	Commonwealth Bank of Australia Ltd	7.36%
FMG	Fortescue Metals Group Limited	5.93%
ANZ	ANZ Banking Group Limited	5.64%
XRO	Xero Limited	5.01%
NEC	Nine Entertainment Co Ltd	4.67%
AMC	Amcor Limited	4.65%
JBH	JB Hi-Fi Limited	4.60%
TLS	Telstra Corporation Limited	4.40%
GMG AE	Goodman Group	4.16%

Source: Pendal as at 31 October 2020

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
NEC	Nine Entertainment Co Ltd	4.50%
JBH	JB Hi-Fi Limited	4.28%
XRO	Xero Limited	4.26%
FMG	Fortescue Metals Group Limited	4.24%
AMC	Amcor Limited	3.88%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Billiton Limited (not held)	-5.83%
WBC	Westpac Banking Corporation (not held)	-3.79%
WES	Wesfarmers Limited (not held)	-3.05%
WOW	Woolworths Group Limited (not held)	-2.82%
RIO	Rio Tinto Limited (not held)	-2.01%

Source: Pendal as at 31 October 2020

#The Portfolio's dividend yield represents the weighted average 12-month forward-looking dividend yield of the portfolio holdings (excluding cash), as at the date of the Factsheet. Each individual security's dividend yield is calculated using market consensus Dividend Per Share (DPS) before tax and franking credits, collated by Pendal and divided by the closing market price of the security as at the date of the Factsheet. The portfolio dividend yield therefore is only an estimate, and does not reflect the actual returns of the Fund, which will be affected by market movements in the price of individual securities, the returns on other assets such as cash holdings and variances of individual security's actual dividends from the forecasted DPS.

Performance

	1 month	3 month	6 month	1 year	Since inception (p.a.)*
Pendal Sustainable Future Australian Shares Portfolio	3.01%	3.70%	11.61%	0.51%	6.34%
S&P/ASX 300 (TR) Index	1.89%	1.22%	9.09%	-7.91%	2.76%
Active return	**1.12%**	**2.48%**	**2.52%**	**8.42%**	**3.59%**

Source: Pendal as at 31 October 2020
*Since Inception - 16 June 2018
Performance returns are pre-fee. Investors should contact their platform provider for applicable fee rates.
Past performance is not a reliable indicator of future performance.

Top 5 contributors - monthly

Code	Name	Value Added
NEC	Nine Entertainment Co Ltd	0.73%
BHP	*BHP Billiton Limited (not held)*	*0.44%*
XRO	Xero Limited	0.34%
FMG	Fortescue Metals Group Limited	0.19%
ANZ	ANZ Banking Group Limited	0.14%

Top 5 detractors - monthly

Code	Name	Value Added
ALX	Atlas Arteria	-0.33%
AMC	Amcor Limited	-0.22%
APT	*Afterpay Limited (not held)*	*-0.21%*
WBC	*Westpac Banking Corp (not held)*	*-0.16%*
RHC	Ramsay Health Care Limited	-0.15%

Top 5 contributors - 1 year

Code	Name	Value Added
FMG	Fortescue Metals Group Limited	2.63%
XRO	Xero Limited	1.80%
JBH	JB Hi-Fi Limited	1.41%
MTS	*Metcash Trading Limited* (not held)	*1.23%*
EVN	Evolution Mining Limited	1.23%

Top 5 detractors - 1 year

Code	Name	Value Added
QAN	Qantas Airways Limited	-1.24%
IAG	Insurance Group Australia	-1.03%
APT	*Afterpay Limited (not held)*	*-0.88%*
ALX	Atlas Arteria	-0.76%
WES	*Wesfarmers Limited (not held)*	*-0.71%*

Source: Pendal as at 31 October 2020.
Underweight positions are in italics.

Stock-specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Nine Entertainment (NEC, +19.2%)

NEC continued its rebound as the market gained more confidence in the domestic recovery story and a return of advertising demand. The broadcaster and publisher has moved swiftly to reduce its cost base, helping offset this effect. Parts of its digital business such as streamer Stan have seen improving trends through Covid. The net effect is that NEC's outlook is much better than many feared.

Underweight BHP (BHP, -5.1%)

BHP delivered a reasonable quarterly production report in October, with iron ore volumes up 7% year-on-year. Copper production was down slightly due to the operational impact of Covid at its Escondida mine. Its development program remains on track. But there are signs the iron ore sector, having done so well over the year, is now a funding source for the recent rotation to the banks. The underweight here – due to BHP's fossil fuel exposure – was beneficial.

Overweight Xero (XRO, +9.33%)

Tech growth stocks such as XRO shrugged off higher bond yields and delivered another month of gains. We are wary of valuations among some of these stocks. However, we see fundamental support for XRO, particularly with federal Budget measures to accelerate investment and stop small businesses from going under.

Three largest detractors

Overweight Atlas Arteria (ALX, -7.1%)

A rise in long-term bond yields – from 0.68% to 0.85% for the US 10 years – dragged on the infrastructure names, including toll road operator Atlas Arteria (ALX, -7.1%). The market remains cautious over the acceleration of Covid cases and newly declared lock-down in France.

Overweight Amcor (AMC, -3.4%)

AMC enjoyed strong gains after an investor briefing early in the month. But it gave this back as the market sold off towards the end of October. AMC remains our preferred defensive industrial, with a strong focus on shareholder return. Its commitment to have all its packaging recyclable or reusable by 2025 underpins its sustainability credentials.

Underweight Afterpay (APT, +20.9%)

Afterpay (APT) is up more than 235% for the year. It has benefited from several near-term Covid-related tailwinds such as a shift to online shopping. However we see these receding. We think valuations do not reflect structural risks around margins as competition emerges. Our preference in the tech growth area remains Xero (XRO).

Market outlook

The "Blue wave" did not emerge in the US election. While the Democrats are set to take the White House, they underperformed expectations in both Houses. Their majority in the House of Representatives was reduced, while the Senate looks set to retain a republican majority. The Democrats have done worse than expected in the House of Representative but should retain a smaller majority.

The prospect of divided government means lower likely stimulus, but also less chance for some of the more contentious policy changes such as higher taxes. Without the control of Congress, Joe Biden is likely to plump for a more centrist cabinet, potentially taking some of the more left wing agenda off the table. Biden has a strong relationship with Republican Senate Leader McConnell, which may be constructive for some degree of cooperation. All in all, the outcome has been broadly welcomed by markets.

Covid cases continued to deteriorate throughout Europe and the US, with increased test positivity indicating growing momentum.

Total US hospitalisations are approaching the earlier peaks in the crisis. In this instance they are spread wider geographically and there are no signs of strain on the system as yet. However, this remains a key factor to watch.

Several European countries reinstated lock downs but the market seems to be taking a relatively sanguine view at this point and appears to be looking through this wave. Sentiment remains bolstered by a combination of:

- A better understanding of the virus
- Better healthcare system preparation
- A view that lockdowns work within a reasonable time frame
- Policy ready to plug the economic gap
- Liquidity so prevalent that any sell-off is quickly supported
- Optimism on positive vaccine developments

The prospect of further trade friction with China remains a risk to Australian equities. There has been speculation of additional measures on some goods such as low-grade iron ore. This is an issue that must be watched.

Several positives are lining up which can support the market into the year's end. These include:

1. Supportive global markets
2. Fiscal stimulus flowing through from the Budget
3. Melbourne re-opening, perhaps more quickly than hoped
4. Borders re-opening
5. Pent-up demand, with more people than usual staying in Australia over Christmas
6. More stimulus from the RBA
7. Cautious positioning from investors
8. The potential for M&A activity

As a result, we remain reasonably constructive on markets near term. However, we retain our balanced portfolio construction, rather than making a binary call on the outcome of the health and economic issues. This reflects heightened uncertainty prevailing in the macroeconomic environment.

New stocks added and/or stocks sold to zero during the month

Add a new position in BlueScope Steel (BSL)

BlueScope is primarily a maker of flat steel products for building and construction – and auto manufacturing in North America via its North Star subsidiary. It is the third-biggest maker of painted and coated steel products globally, led by its Colorbond brand. In 2019, 38% of its revenue came from Australia and just under 35% from North America. The balance is spread among smaller building and construction-focused businesses across Asia.

BSL's profitability is driven largely by the spread between steel prices and the cost of inputs. This spread has been hard hit by a collapse in demand for steel due to Covid-19. As a result, BSL has been trading just over 20% below its pre-Covid highs.

However, we see emerging support for a recovery in steel spreads which should help the stock recover as the market gains confidence in a normalisation of economic activity.

In Asia, Chinese steel production has remained largely impervious to the effects of Covid-19 as infrastructure-related stimulus measures enacted 12-18 months ago drive demand. Authorities have continued to approve developments in response to Covid-19. Credit growth – a lead indicator of demand – continues to trend up in response to looser monetary policy. This should underpin a multi-year runway of steel demand. Lead indicators in other areas such as property are also picking up, providing an additional avenue of demand growth.

Critically, China has not been adding to steel production capacity, which was slashed two years ago via the closure of older, high-polluting mills. Other big Asian producers are also maintaining supply discipline. Japan has been cutting capacity for the first time in decades in response to the reduction in global demand outside China. A combination of continued growth in Chinese demand, a rebound elsewhere in the region and supply capacity discipline should help support a material rebound in steel spreads.

Steel spreads in North America blew out in recent years in response to the Trump tariffs. Producers moved to benefit from this, with material new capacity approved, mainly in the form of electric arc furnaces which burn scrap and are less capital intensive than traditional blast furnaces which use iron ore. This raised material risk of oversupply in the North American market. However this has been alleviated by Covid-19 as the collapse in demand accelerated the closure of some higher-cost blast furnaces. There has also been industry consolidation with the first and third-biggest blast-furnace operators merging, which should see a permanent reduction in capacity.

These supply-side moves, coupled with a recovery in demand, are supportive for a rebound in spreads on a 12-18 month view. The auto industry, an important consumer of flat steel in North America, should play an important role as low inventory levels spark a period of restocking.

From the aspect of sustainability, we regard steel-making as an essential aspect of development and improving quality of life. However BSL is also notable in its approach to the industry's sustainability, particularly in the aspect of gender diversity. Here it can be considered a leader not just in its sector but in the market more broadly.

High-profile gender diversity debate exist at board level but the opportunity to improve female participation exists right across the workforce – even (or perhaps especially) in traditionally male-dominated industries. BlueScope Steel's approach to diversity is notable in this regard. Its North American business BlueScope has changed shift schedules to attract and retain female employees.

It has also launched an advertising and awareness campaign to drive greater female participation in its operations team.

Since FY16 the percentage of women on BlueScope's board has increased by just over half from 25% to 38%. The percentage in executive roles has almost doubled from 14% to 27%.

The biggest proportional increase has come in its operational workforce, which has almost tripled from 4% to 11%. While still low in an absolute sense, this big proportional increase shows the potential for swift results when a focused effort is made.

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